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IN THE

Supreme Court of the United States

October Term, 1937.

No. 597

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

CLARENCE M. FREEDMAN, *Respondent.*

BRIEF FOR THE RESPONDENT.

This case is before the Court on petition for certiorari to the United States Circuit Court of Appeals for the Third Circuit to review the judgment of that court reported in 92 F. (2d) 150, which reversed the decision of the United States Board of Tax Appeals reported in 34 B. T. A. 956.

The petition for the writ was granted December 6, 1937, and this case set for argument to follow *McLoughlin* v. *Commissioner,* No. 287, present term, here on writ of certiorari to the Circuit Court of Appeals for the Second Circuit, to review its judgment reported in 89 F. (2d) 699. The *McLoughlin* case is preceded on the argument list by *Commissioner* v. *Therrell,* No. 128, present term, and *Commis-*

sioner v. *Tunnicliffe*, No. 129, present term, both of which are here on writs of certiorari to the Circuit Court of Appeals for the Fifth Circuit, to review judgments of that court reported in 88 F. (2d) 869, and 88 F. (2d) 873, respectively. These several cases involve a similar question of Federal Constitutional law, the opinion in the *McLoughlin* case being in conflict with the opinion in the other three cases.

Question Involved.

Was the annual salary of $3,000 received by respondent in 1932 for services rendered as an attorney in the Department of Justice of the Commonwealth of Pennsylvania immune from Federal income taxation?

Statement of the Case.

On October 2, 1931, Freedman was appointed an attorney in the Department of Justice of the Commonwealth of Pennsylvania with a salary at the rate of $3,000 per annum, and was assigned to the liquidation work of the Department of Banking. In his 1932 income tax return he did not include such $3,000 salary in taxable income because "the Department of Justice in Pennsylvania had taken the matter up with the Commissioner of Internal Revenue in Washington and had secured a ruling which was submitted to all attorneys in the form of a memorandum to the effect that our salaries were not taxable" (R. 33). This ruling is set forth at R. 34-36. His return was examined by a Revenue Agent who advised that the salary was exempt (R. 33).

In his audit of the return the Commissioner included the salary in taxable net income on the ground that "state employees whose compensation is paid from funds of banks being liquidated are subject to Federal income tax (R. 7-8), and accordingly determined a deficiency in income tax against Freedman for the year 1932 in the amount of $142.70 (R. 5-9). From this determination he prosecuted an appeal to the Board of Tax Appeals (R. 3) which, after

a hearing, promulgated its findings of fact and opinion, holding petitioner's salary was taxable and affirming the Commissioner's determination (R. 11-21). The basic ground of the Board's decision denying petitioner's claim to immunity, as stated in its opinion, was that "the source of his income precludes any possibility of a burden on the State resulting from a tax" on his salary.

Freedman thereupon petitioned the Circuit Court of Appeals for the Third Circuit for a review of the Board's decision. That court reversed the Board, with an opinion (R. 62-65) in which it held:

> "Being an employee of the State or the Nation, being engaged in recognized governmental work—in this case the vital Department of Banking (Therrell v. Commissioner, 88 Fed. (2d) 869)—it follows that the quantum of the employee's pay, the means by which he is paid, are features which do not on the one hand determine the liability of the national employee to state taxes or the state employee to federal taxes. The Nation and the State, within their respective spheres of governmental administration, are not subject to taxation imposed by other sovereignties."

The Board made Findings of Fact which are very complete and fully supported by the evidence. These findings are set forth at R. 11-16 and are repeated in the Statement in the Commissioner's brief. They are not, therefore, restated here.

In his petition for the writ and in his brief the Commissioner specified four errors which appear to raise questions as to (1) whether Freedman was an employee of the State or an independent contractor, (2) whether his services were rendered in connection with a governmental function, and (3) whether the doctrine of reciprocal tax immunity is affected by considerations of how or where the State secured the funds with which to pay Freedman's salary. However, the Commissioner's argument is devoted exclusively to the two questions last stated. It may be in-

ferred, therefore, that in this Court, as in the court below, the Commissioner does not deny that Freedman was an "employee" of the State in the commonly accepted sense of that term.

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix to the Commissioner's brief. The regulation which seems controlling on the precise question presented is Article 643 of Treasury Regulations 77, promulgated February 10, 1933, under the Revenue Act of 1932. That article provides:

> "Art. 643. *Compensation of State officers and employees.*—Compensation paid to its officers and employees by a State or political subdivision thereof for services rendered in connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (a) the person receives such compensation as an officer or employee of a State or political subdivision, and (b) the services are rendered in connection with the exercise of an essential governmental function. The commissions of receivers appointed by State courts are taxable.
>
> An officer is a person who occupies a position in the service of the State or political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary."

Summary of Argument

The index of the points covered by the argument, appearing at the front of this brief, will serve also as a summary of the argument presented on behalf of the respondent.

ARGUMENT.

The errors specified by the Commissioner in this case, as stated in his brief, are substantially the same as those specified by him in the *Therrell* and *Tunnicliffe* cases (Nos. 128 and 129, present term). Except that here he makes no specific argument that Freedman was not an employee of the State, the Commissioner's argument in this case is substantially the same as in those cases. His main discussion is contained in his brief in the *Therrell* case, and our argument will be directed primarily to answering the points there made.

Three independent questions are presented: (1) whether respondent was an employee of the Commonwealth of Pennsylvania; (2) whether respondent was employed in carrying out governmental functions of that State; and (3) whether respondent's claim to immunity from Federal income tax on his salary is affected by the fact that such compensation was paid out of the assets of closed banks, expropriated by the State to pay the expenses of liquidating those banks, and was not paid out of revenues derived by the State through general taxation.

At the outset it may be noted that the Commissioner in his brief in the *Therrell* case (p. 9) says that he is not asking for a re-examination of the cases which have established and applied the reciprocal tax immunity doctrine. Essentially, however, his argument is directed to the validity of the fundamental principles as stated in the decided cases, and which heretofore have been considered as so firmly fixed as to be unalterable except by amendment to the Federal Constitution. Clearly the Commissioner seeks to establish limitations on the immunity doctrine not heretofore recognized by the courts prior to the decision in the *McLoughlin* case now under review (No. 287, present term).

I. The Federal Government is without constitutional power to tax the compensation of an officer, employee or other instrumentality employed by the state to carry out appropriate governmental functions, and the source of the funds used by the state to discharge its obligation to pay such compensation is immaterial.

The principal trouble with the Commissioner's argument is the failure to recognize fundamental principles of constitutional law. A due recognition of those well-established principles makes the solution of the problem here comparatively easy. We feel, therefore, that it is desirable to review certain of the cases in which the doctrine of immunity has been given effect, even though this may considerably lengthen our brief.

1. *For almost a century it has been recognized that tax immunity extends to fixed salaries and compensation paid to governmental officers and employees in their capacity as such.*

The Commissioner's brief in the *Therrell* case proceeds on the theory that the Federal Government does have Constitutional jurisdiction to tax the salary of a State employee and that whether it may exercise such jurisdiction depends upon whether, in a particular case, there has been a showing of some positive burden on or interference with the carrying out of a governmental function by the State. While in the decided cases *one reason* assigned by this Court in support of the immunity doctrine has been the possibility or actuality of some burden, financial or otherwise, in a given case, the *fundamental reason* for this doctrine is the inherent lack of Constitutional power in the Federal Government to invade the field of governmental powers reserved to the States, on the one hand, and the lack of similar power in the State to invade the field of governmental powers delegated to the National Government. The very existence of the unique form of our dual constitutional government, operating in the same territorial jurisdiction, requires strict adherence to principles which preclude one

government from asserting its taxing power upon any appropriate means adopted by the other government to carry out its constitutional functions in its particular sphere of operations.

It is thus upon the basis of this lack of Constitutional power over the subject matter that the one government is denied the right to tax the governmental instrumentalities of the other. *The essence of the rule is lack of jurisdiction to lay a tax.* The situation is the same as though the officer, employee or other governmental agency were without the territorial jurisdiction of the government attempting to lay the tax.

The foregoing principles appear clearly established by the many decisions of this Court which consider the application of the immunity rule, both in the field of taxation and in other fields. Within the month the Court has carefully considered and reviewed many of them in the important case of *James* v. *Dravo Contracting Company,* No. 3, present term. For this reason no attempt will here be made to analyze any of the cases except those bearing *directly* on the question of immunity of governmental officers and employees.

Before proceeding to a brief analysis of those few cases, however, it may be observed that a careful examination of the decisions dealing with tax immunity discloses that the principal difficulty in particular cases has been that of differentiating between what are government agencies and instrumentalities, and what are not. No case has been found where a tax has been upheld upon an agency of either the State or Federal Governments, which was admitted or found to be carrying out essential government functions. For this reason the Court has met no difficulty in those cases where an officer or employee was involved, for such agencies are everywhere conceded of necessity to be agents or instrumentalities of the government for which they work. Government must function through persons. Only through the services of persons can the government serve its citizens. That is axiomatic. Hence the cases which have given rise to problems difficult of solution have been those where

no direct employer-employee relationship is shown. Such cases are those where the person or agency involved was so independent of government as to have freedom of action in functioning, and where the work to be performed was prescribed primarily by contract and not by statutes or by regulations and edicts predicated upon statutory authority.

While the immunity principle in relation to officers and employees (conceded or proven to be such) is adverted to in many cases it has been applied to such governmental agencies in but four cases decided by this court.

Dobbins v. *Commissioners,* 16 Pet. 435 (1842), held that a State cannot tax an officer of the United States, for his office, or its emoluments. Dobbins was a captain in the United States revenue-cutter service, stationed at Erie, Pennsylvania, and the tax was a county tax assessed upon "all offices and posts of profit, professions, trades, and occupations, having a due regard to the profits arising therefrom". In the Commissioner's brief (pp. 18-19) in the *McLoughlin* case, the Solicitor General appears to ignore the principal ground assigned by the Court for its conclusion in the *Dobbins* case, *i. e.*, the lack of power in one government to interfere with the constitutional means employed by the other government. He refers to two other grounds there stated, which appear to deal merely with financial burden, in the one case on the State itself and in the other on the employee. He asserts that the latter of these two grounds has been overruled in the *Dravo* decision. We do not believe that there is anything in the *Dravo* case (which dealt with an admitted non-governmental instrumentality) that is inconsistent even with the reasoning in the *Dobbins* case (which dealt with an admitted governmental instrumentality). Certainly the main ground stated in the *Dobbins* opinion has not been overruled but, on the contrary, strongly reaffirmed. Both because it is necessary to correct the Commissioner's statement of this Court's reasons for the *Dobbins* decision, and because the language of the Court there is so appropriate to the proposed tax on Freedmen's salary, it is quoted somewhat at length. After pointing out at pages 445-446 that:

"*The emoluments of the office, then, are taxable, and not the office.* But, whether it be one or the other, we cannot perceive how a tax upon either conduces to comprehend within the terms of the act, the office or the compensation of an officer of the United States. It will not do to say, as it was said in argument, that though the language of the act may import that offices and posts of profit were taxable, that it was the citizen who holds the office whom the law intended to tax, and that it was a burden he was bound to bear in return for the privileges enjoyed, and the protection received from government; and, then, that the liability to pay the tax was a personal charge, because the person upon whom it was assessed was a taxable person.

The first answer to be given to these suggestions, is, that the tax is to be levied upon a valuation of the income of the office.

* * *

Taxes are never assessed, unless it be a capitation tax, upon persons as persons, but upon them on account of their goods, and the profits made upon professions, trades, and occupations."

the Court held:

"Taxation is a sacred right, essential to the existence of government; an incident of sovereignty. The right of legislation is coextensive with the incident, to attach it upon all persons and property within the jurisdiction of a State. But in our system there are limitations upon that right. There is a concurrent right of legislation in the States and the United States, except as both are restrained by the constitution of the United States. Both are restrained upon this subject, by express prohibitions in the constitution; and the States, by such as are necessarily implied when the exercise of the right by a State conflicts with the perfect execution of another sovereign power, delegated to the United States. *That occurs when taxation by a State acts upon the instruments, emoluments, and persons which the United States may use and employ as necessary and proper means to execute their sovereign powers.*

* * *

But the unconstitutionality of such taxation by a State as that now before us may be safely put—*though it is not the only ground—upon its interference with the constitutional means* which have been legislated by the government of the United States to carry into effect its powers to lay and collect taxes, duties, imposts, etc., and to regulate commerce. In our view, it presents a case of as strong interference as was presented by the tax imposed by Maryland, in the case of M'Culloch, 4 Wheat. 316; and the tax by the City Council of Charleston, in Weston's Case, 2 Pet. 449; in both of which it was decided by this court, that *the state governments cannot lay a tax upon the constitutional means employed by the government of the Union to execute its constitutional powers.*

But we have said that the ground upon which we have just put the unconstitutionality of the tax in the case before us, is not the sole ground upon which our conclusion can be maintained. *We will now state another ground;* and we do so *because it is applicable to exempt the salaries of all officers of the United States from taxation by the States.*

The powers of the national government can only be executed by officers whose services must be compensated by congress. The allowance is in its discretion. *The presumption is that the compensation given by law is no more than the services are worth,* and only such an amount as will secure from the officer the diligent performance of his duties. 'The officers execute their offices for the public good. This implies their right of reaping from thence the recompense the services they may render may deserve;' without that recompense being in any way lessened, except by the sovereign power from whom the officer derives his appointment, or by another sovereign power to whom the first has delegated the right of taxation over all the objects of taxation, in common with itself, for the benefit of both. And no diminution in the recompense of an officer is just and lawful, unless it be prospective, or by way of taxation by the sovereignty who has a power to impose it; and which is intended to bear equally upon all according to their estate.

The compensation of an officer of the United States is fixed by a law made by congress. It is in its exclu-

sive discretion to determine what shall be given. It exercises the discretion and fixes the amount, and confers upon the officer the right to receive it when it has been earned. *Does not a tax, then, by a State upon the office, diminishing the recompense, conflict with the law of the United States, which secures it to the officer in its entireness?* It certainly has such an effect; and any law of a State imposing such a tax cannot be constitutional, because it conflicts with a law of congress made in pursuance of the constitution, and which makes it the supreme law of the land."

The doctrine was next applied in the case of *Collector* v. *Day*, 11 Wall. 113, (1870) where it was established to be a reciprocal rule. Day was a county probate judge in Massachusetts. The Court held the Federal income tax provided in the Act of 1864 invalid as applied to his official salary. The Court said the same considerations which require the compensation of a Federal official to be held exempt require that of a State official to be immune, and approved the reasoning of the *Dobbins* case, saying:

"In *Dobbins* v. *The Commissioners of Erie County*, it was decided that it was not competent for the legislature of a State to levy a tax upon the salary or emoluments of an officer of the United States. *The decision was placed mainly upon the ground that the officer was a means or instrumentality employed for carrying into effect some of the legitimate powers of the government, which could not be interfered with by taxation or otherwise* by the States, and that the salary or compensation for the service of the officer was inseparably connected with the office; that if the officer, as such, was exempt, the salary assigned for his support or maintenance while holding the office was also, for like reasons, equally exempt."

The next cases involving compensation for personal services rendered were *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514 (1925) and *Helvering* v. *Powers*, 293 U. S. 214 (1934). Both cases seem to have been decided on the ground that the taxpayer was not a true governmental instrumentality—in the *Metcalf & Eddy* case because there was an indepen-

dent contractor status, and in the *Powers* case because he was not carrying out usual governmental functions.

Then came *New York ex rel. Rogers* v. *Graves*, 299 U. S. 401 (1937), where the New York income tax was held invalid as applied to the salary of the General Counsel of the Panama Railroad Company, a corporation which the Court held to be a Federal instrumentality carrying out appropriate governmental functions. The reasons for the immunity rule were not discussed but the previously established rule was accepted without question and applied, the Court holding:

> "The railroad company being immune from state taxation, it necessarily results that fixed salaries and compensation paid to its officers and employees in their capacity as such are likewise immune."

The most recent case squarely in point is *Brush* v. *Commissioner*, 300 U. S. 352 (decided March 15, 1937). Brush was Chief Engineer of the Bureau of Water Supply of the City of New York. The Court held the Federal Government could not lay an income tax on his official salary. The only question discussed was whether he was engaged in a governmental function, and was thus a governmental instrumentality. Holding that he was so employed, the Court said it necessarily followed that his salary was exempt from tax because "fixed salaries and compensation paid to its (the municipality's) officers and employees in their capacity as such" are immune.

2. *The recent decision in James* v. *Dravo Contracting Co. unanimously states and reaffirms the basic principle applied in previous cases.*

In that case the Court held a State could collect a tax laid upon the gross receipts of a corporation under contracts with the United States, where an independent contractor relationship resulted from such contracts. The Court was careful to point out that:

"The tax is not laid upon the Government, its property or officers. *Dobbins* v. *Commissioners,* 16 Pet. 435, 449, 450.

The tax is not laid upon an instrumentality of the Government. *McCulloch* v. *Maryland,* 4 Wheat. 316; *Osborn* v. *The Bank of the United States,* 9 Wheat. 738; *Gillespie* v. *Oklahoma,* 257 U. S. 501; *Federal Land Bank* v. *Crosland,* 261 U. S. 374; *Clallam County* v. *United States,* 263 U. S. 341; *New York ex rel. Rogers* v. *Graves,* 299 U. S. 401. Respondent is an independent contractor."

That governmental officers, employees and other direct instrumentalities are Constitutionally immune seems to be the position of all nine Justices of this Court. This appears not only from the above quotation from the opinion of Mr. Chief Justice Hughes, concurred in by four Justices, but from other statements he makes. It is emphasized by the analysis of the decisions in *Telegraph Company* v. *Texas,* 105 U. S. 460, *Leloup* v. *Port of Mobile,* 127 U. S. 640, and *Williams* v. *Talladega,* 226 U. S. 404. The Court pointed out that in those cases the independent contractor had been considered as the *agent* of the government to conduct essential public business It thus appears that even an independent contractor, if especially constituted an instrumentality to carry out governmental functions, may be entitled to tax immunity on the payments received pursuant to such an agency arrangement.

That the decision in the *Dravo* case specifically supports the respondent's contentions in this case is further evident when we consider the views expressd by Mr. Justice Roberts and the three other Justices who joined with him in the dissent. As the very basis of that dissent they reaffirm the principles contended for by respondent here, saying:

"The doctrine which forbids a state to interfere with the exercise of federal powers does not have its origin in the common law exemption of the sovereign from regulation or taxation. It springs from the necessity of maintaining our dual system of government. 'The at-

> tempt to use it (the power of taxation) on the means employed by the government of the Union, in pursuance of the constitution, is itself an abuse, because it is the usurpation of a power which the people of a single State cannot give. We find, then, on just theory, a total failure of this original right (of the states) to tax the means employed by the government of the Union, for the execution of its powers.' 'The immunity is derived from the Constitution in the same sense and upon the same principle that it would be if expressed in so many words.'
>
> * * *
>
> *In its application the principle forbids taxation by a state of property of the federal government, or of the office or salary of any of its officers.''*

Mr. Justice Roberts, after pointing out that "admittedly the appellee is not an agency or instrumentality of the United States," proceeds to considerations favorable to extending immunity in that case to such an admitted non-governmental agency. Thus the full Court seems to have concurred in the view that in all events a tax cannot be laid upon a governmental officer or on his salary, solely because he is such an instrumentality of the one government that the other is without Constitutional power to lay the tax. Mr. Justice Roberts in his opinion also said:

> "Chief Justice Marshall denied the existence of the power. From that day to this the court has consistently held that the question is not one of quantum, not one of the weight of the burden, but one of power."

In the *Dravo* decision, the Court emphasized that the earnings of the independent contractor do not stand "upon the same footing as interest upon governmental securities or the income of an instrumentality of government," pointing out that it was so held in *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514. With further reference to that case Mr. Chief Justice Hughes said:

> "The reasoning upon which that decision was based is controlling here. We recognized that in a broad sense

'the burden of federal taxation necessarily sets an ecomic limit to the practical operation of the taxing power of the States and *vice versa.*' *'Taxation by either the state or the federal government affects in some measure the cost of operation of the other.'* As 'neither government may destroy the other, *or control in any substantial manner the exercise of its powers,'* we said that the limitation upon the taxing power of each, so far as it affects the other, 'must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax . . . or the appropriate exercise of the functions of the government affected by it.' *Metcalf & Eddy* v. *Mitchell, supra,* pp. 523, 524.

We said further that the nature of the governmental agencies or the mode of their constitution could not be disregarded in passing on the question of tax exemption, as it was obvious that *an agency might be of such a character or so intimately connected with the exercise of a power or the performance of a duty by the one government 'that any taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power.' And it was on that principle that 'any taxation by one government of the salary of an officer of the other, or the public securities of the other, or an agency created and controlled by the other, exclusively to enable it to perform a governmental function,' was prohibited.* We concluded that a non-discriminatory tax upon the earnings of an independent contractor derived from services rendered to the Government could not be said to be imposed 'upon an agency of government in any technical sense' and could not 'be deemed to be an interference with government or any impairment of the efficiency of its agencies in any substantial way.' Id. pp. 524, 525."

The pith of the decision in the *Dravo* case seems to be that tax immunity may not generally be extended to the independent contractor, for he is not *per se* an instrumentality of government, but must always be extended to—

> "taxation by one government of the salary of an officer of the other, or the public securities of the other, or an agency created and controlled by the other, exclusively to enable it to perform a governmental function."

Read together, accepting both their *statement* of the rule, and the reasons asigned therefor, *Dobbins* v. *Commissioner*, *Collector* v. *Day*, *Rogers* v. *Graves*, *Brush* v. *Commissioner*, *Metcalf & Eddy* v. *Mitchell* and *James* v. *Dravo Contracting Company*, establish the principles that a governmental officer or employee is *per se* an instrumentality of the sovereign which employes him and, if engaged in carrying out functions appropriate to government, his compensation is immune solely because neither a State nor the Federal Government has Constitutional power to tax a governmental agency or instrumentality of the other government. The two last mentioned cases seem to establish the reverse principle that an independent contractor is not *per se* an instrumentality of government, and hence a tax on his compensation is generally to be held valid.

In the *Dravo* case the Court has thus again approved and applied the test long applied by the lower courts, the Board of Tax Appeals and the Treasury Department itself in cases like the present—namely, is the taxpayer an officer or employee, or is he an independent contractor? It is a practical test, and one which the courts and the Board have found no great difficulty in applying. The principles for distinguishing officers and employees from independent contractors have become fairly well settled. The reaffirmance of the validity of this test of immunity should serve to eliminate much litigation in the field of Federal taxation.

The foregoing cases are so consistent, so explicit and so squarely in point (assuming, as we do for this part of our brief, that Freedman was a State employee engaged in carrying out governmental functions) that there would seem to be little room for argument left.

3. *The Commissioner's contention that the source of the funds used by the State to pay its employee's compensation limits the right to immunity, has never received the sanction of this Court, and is inconsistent with both the statement of and reasons for the immunity doctrine.*

Clearly, aside from the decision of the Circuit Court in the *McLoughlin* case, the contention of the Commissioner has never received judicial sanction. This Court has never suggested any such limitation on the immunity principle. In fact in both the *Rogers* and *Brush* cases the compensation was not paid out of funds raised by taxation. Rogers was paid out of earnings of a railroad, and Brush out of charges for water furnished, but such facts were not considered to affect their right to immunity as governmental instrumentalities. Indeed, until recently both the Treasury Department and the Board of Tax Appeals have never considered the source of the compensation to be material in determining the right to exemption from the Federal income tax. This is shown in Point II of the Brief for the Petitioner in the *Therrell* case (No. 287, present term). Furthermore, there have been a considerable number of court decisions involving officials who were not paid directly by the State or a political subdivision thereof and who have been held exempt from Federal income tax. See the analysis of such cases at page 30 of that same brief.

Not only is the Commissioner's contention without judicial sanction but we believe the rule for which he contends is wholly inconsistent with the very reasons for the immunity doctrine. Certainly this Court in all its *statements of the rule* has never referred to any such limitation that the source of the funds affected the right to immunity.

Let us analyze the Commissioner's contention in light of the principles established by the cases already reviewed. *In essence, it must be that the Commissioner asserts that a State officer or employee ceases to be an officer or employee, and thus ceases to be a State instrumentality of govern-*

ment, when his compensation is paid in any way other than out of funds raised by general taxation. This must be so for, as heretofore shown, the very basis for the immunity doctrine is lack of jurisdiction in the Federal Government to tax a State agency. The only way to avoid the application of the rule and to secure authority for the tax is to establish that the person is not a State instrumentality. We thus come to an examination of whether the source of the compensation in any way affects the status of the officer or employee as an instrumentality of his State government.

4. *The source of the State employee's compensation cannot affect his status as an agency or instrumentality of the State Government.*

It seems proper to note that the Commissioner's assertion that Freedman was "paid from private funds" is misleading. The Commissioner's entire argument in his brief in the *Therrell* case is predicated upon the assumption that the taxpayer's compensation was "paid out of private funds" (p. 35). This, however, is but a half-truth and consequently the argument built on such a premise necessarily leads to invalid conclusions. The whole truth is that the taxpayer's compensation was paid out of private funds *expropriated by the sovereign and applied to the use of the sovereign.* The Commissioner appears to have shut his eyes to the fact that all of the costs of government are paid out of private funds. The source of all governmental revenues and of all the funds used by the sovereign to discharge its obligations are necessarily basically "private funds". So a solution to the problem is in nowise aided by starting with the assumption that the source of the compensation is "private funds". Since all governmental expenses are necessarily paid out of private funds commandeered by the sovereign, the argument of the Commissioner amounts to no more than the suggestion that the *method* by which the sovereign obtains the funds with which to discharge its ob-

ligations has some bearing upon the Constitutional question presented. We respectfully submit, however, that the *method* by which the sovereign obtains the particular moneys with which to pay a particular officer or employee has no relevancy whatever to the problem at hand.

To say that Freedman was not in legal effect paid by the State would be to ignore settled principles of constructive receipt. If A owes B money for services rendered by B to A, and if B permits or requires A to pay the salary of one of B's employees, certainly B is considered to have constructively received the money and to be liable for an income tax thereon. Compare *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716. No one would argue that the servant was not paid by B, his own employer. So if there is here any room for the contention that the salary was in fact paid out of the assets of the banks,* it would be immaterial, since in legal effect the situation is the same as though the State's charges for supervising the liquidation proceedings were paid by the banks into the State Treasury, the funds commingled with other revenues, and then paid out in salaries to Freedman and other State employees. In all events the State constructively received the funds used to pay the salary, and in contemplation of law the salary was paid out of funds of the State itself.

The sovereign (whether the Federal Government or a State Government) assuredly may enter into any sort of arrangement it chooses with an officer or employee concerning the amount of compensation and the method of payment. Also there is concededly no limitation on the right of the sovereign to choose the method to be used in obtaining the funds with which to pay the promised com-

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*The Board found (R. 15):

> "Petitioner's salary was paid to him semimonthly by checks drawn by representatives of the state banking department in charge of closed banks in Philadelphia, the checks being countersigned by the secretary of banking at Harrisburg."

pensation. It may pay that salary out of revenues derived through various forms of taxation; it may pay the salary out of fees prescribed for special services and paid into the State treasury; or, as in this case, it may under its broad sovereign powers simply expropriate certain private property in fulfillment of its obligation to compensate the employee for the services rendered to the State. In all such cases it exercises sovereign powers to take over private funds from its citizens to pay public officers and employees.

In early times the judges of England were paid by fees upon the volume of business transacted by them.* In our country not more than half a century ago the fees of United States attorneys deducted from the collection of customs due in litigation, and retained in lieu of salaries, became so large that Congress changed the method of compensation from the fee basis to the annual fixed salary basis.

With these historic precedents in mind, and the countless others of a similar nature that could be cited, how can it be said in this day that the incumbent of an office, paid out of fees, is not an officer of government merely because he is not paid directly out of the treasury of the Crown, of the United States Government or of the State? Is it not a necessary part of the freedom of the sovereign that it may select the method of compensation? It may be that in some cases the fee basis of compensation leads to abuse, in others it may be the most convenient way to reduce the general burden on taxpayers—that is beside the point. The point is that the sovereign must be free, without interference of any kind to choose its means or instrumentalities. That is why the Court said long ago that a tax on the salary of an officer is a tax on the office itself (*Macallen* v. *Mass.*, 279 U. S. 620, 626, citing *Dobbins* v. *Erie County, supra*).

An important consideration to keep in mind is that the

Scott v. *Avery*, 25 L. J. (Exch.) 308, 312, 313; see also, Cohen, Commercial Arbitration and the Law, Chapter XIX, pages 254-256.

collection of fees from those to whom the service is rendered is, in its very nature, a charge for services rendered by government, as was pointed out in the following paragraph from Mr. Justice Sutherland's opinion in the *Brush* case:

> "And to say that, because the city makes a charge for furnishing water to private consumers, it follows that the operation of the water works is corporate and not governmental, is to beg the question. *What the city is engaged in doing in that respect is rather rendering a service than selling a commodity. If that service be governmental it does not become private because a charge is made for it, or a profit realized.* A state, for example, constructs and operates a highway. It may, if it choose, exact compensation for its use from those who travel over it (see *Bingaman* v. *Golden Eagle Lines*, 297 U. S. 626, 628); but this does not destroy the claim that the maintenance of the highway is a public and governmental function. The state or the city may exact a tuition charge for instruction in the public schools; but thereby the maintenance of the public schools does not cease to be a function of the government. *The state exacts a fee for issuing a license or granting a permit; for recording a deed; for rendering a variety of services in the judicial department. Do these various services thereby lose their character as governmental functions?* The federal Post-Office Department charges for its services; but no one would question the fact that its operation calls into exercise a governmental function." 300 U. S. 352, 372.

Most important in this case are the facts that respondent was engaged by the State, promised a salary by the State, rendered services to the State, and that the legal obligation to pay the salary was that of the State. Much of the Commissioner's argument is invalid because of failure to give due recognition to such all-controlling facts.

Respondent was not employed by the closed banks; the banks had nothing to do with his selection nor with the terms of his employment. Hence the State, acting through its Attorney General who acted pursuant to statutory au-

thority "to appoint and fix the compensation * * * of Special Attorneys to represent the Commonwealth" (R. 12), in writing employed respondent as "an attorney in this Department" at a salary "at the rate of $3000.00 per annum" (R. 12). Hence he was engaged by the State and promised a fixed salary by the State itself. The Commissioner's argument seems to ignore these facts. The claim is that respondent was paid out of "private funds". The Board found, however, that (R. 15):

> "Petitioner's salary was paid to him semimonthly by checks drawn by representatives of the state banking department in charge of closed banks in Philadelphia, the checks being countersigned by the secretary of banking at Harrisburg. In the early part of 1932 his salary was charged against funds of three closed banks whose assets had been taken over by the secretary of banking, but later in the year it was charged against funds of four closed banks, although his services were not confined to matters relating to the affairs of those particular banks. The banks against which the petitioner's salary was charged were determined by the attorney general and the secretary of banking. The salaries of attorneys handling matters relating to the several closed banks were ordinarily paid out of the funds of such banks in approximate proportion to the amount of work done for each bank."

In this case, therefore, we do not have a situation where a public servant renders a direct service to a private person or corporation. Here it was the State which had exercised its sovereign power to take over the banks and supervise their orderly liquidation in the public interests. *Respondent was but an instrumentality of the State in rendering that public service.* The State itself, and not Freedman, rendered the service to the closed banks.

Thus respondent's salary was actually paid by the State out of moneys legally in its possession. How it got the funds seems wholly immaterial *as the legal obligation to pay the salary was clearly that of the State.* From respondent's

standpoint, and from the standpoint of this case, it matters not what accounting the State might have made to the banks. It took physical possession of the private funds and expropriated the same for the purpose of paying obligations incurred by the State in its own name and for its own public purposes.

Here the State undertook to liquidate the assets of the banks. The legislature could have defrayed the expenses of the State out of the general funds in its Treasury, or out of prescribed fees charged for particular services, or out of the funds of the banks which were in custody of the State. The latter method was chosen—probably because it appeared to be the most equitable. Clearly it is more desirable to charge the cost of the public supervision services against that portion of the public (*i. e.*, the depositors, stockholders and creditors of the bank) who most directly benefited. The method used is essentially the fee method, for a fee is nothing but a pre-estimated cost of a given service. However, here the amount charged was limited to actual cost, and amounted merely to a special assessment against the banks' funds in the amount of the specific expenses incurred by the State.

It is thus clear that neither the method used by the State in securing the funds to pay Freedman his salary nor the source of those funds in any way changes his status as a State instrumentality. That being so, he is clearly entitled to exemption, if the only objection be that as to the source of his compensation.

5. *It has always been recognized that taxation of a governmental officer or employee lays an unconstitutional burden on the sovereign, and that the degree of the burden is immaterial.*

Since right to immunity results from an inherent lack of jurisdiction in one sovereign to tax the governmental agency of the other sovereign, obviously it is immaterial whether a particular tax results in a financial burden. Apparently the

cases have discussed the matters of "burden" and "interference" as illustrative of reasons supporting an interpretation of the Federal Constitution which preserves to each government independence of action in their respective spheres. That the cases have not rested the immunity principle solely upon the possibility of a financial burden is stated in the *Dobbins* case, at page 449:

> "But the unconstitutionality of such taxation by a State as that now before us may be safely put—*though it is not the only ground*—upon its interference with the constitutional means which have been legislated by the government of the United States to carry into effect its powers * * *."

The cases have proceeded on the sound assumption that *necessarily* the taxation of the compensation of a governmental employee will burden or interfere with the functions of the government which employs him. That some burden or interference in fact results has been so long and so frequently recognized by the courts as not now to be open for question. In *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523, this Court said:

> "Taxation by either the state or the federal government affects in some measure the cost of operation of the other".

In *Macallen* v. *Massachusetts*, 279 U. S. 620, 628, the Court held:

> "Not only may the power to tax be exercised oppressively, but for one government—state or national—to lay a tax upon the instrumentalities or securities of the other is derogatory to the latter's dignity, subversive of its powers, and repugnant to its paramount authority."

The Solicitor General in his brief in the Dravo Contracting Company, at page 5, said:

> "Any tax will be reflected in greater or less degree in the costs which the sovereign must pay."

Thus to the extent that the question of a *financial burden* is at all material in considering the immunity of a governmental officer or employee, the fact of a burden is judicially determined and admitted by the Government, speaking through its Solicitor General. The fact that there is such a financial burden on the State supports the claim to exemption here, but does not appear in itself to be determinative of the question.

Furthermore, the decisions are unanimous in holding that the extent or degree of the burden or interference is wholly immaterial. As stated in *Indian Motocycle Co.* v. *United States*, 283 U. S. 570, 575:

> "Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute. *McCulloch* v. *Maryland*, 4 Wheat. 316, 430; *United States* v. *Baltimore & Ohio R. Co.*, 17 Wall. 322, 327; *Johnson* v. *Maryland*, 254 U. S. 51, 55-56; *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505; *Crandall* v. *Nevada*, 6 Wall. 35, 44-46."

There is another consideration. Mr. Chief Justice Hughes in the *Dravo* case pointed out that should any State lay a tax in such an amount as to substantially interfere with the Federal Government's power to obtain the service it needs, it has adequate power to prevent such interference. In case, however, the Federal Government should lay a tax of such magnitude as to impede a State in obtaining the service it needs, there is considerable doubt whether it has adequate Constitutional power to prevent such interference. Hence, there is even more reason that no consideration be given to the extent of the interference or to the weight of the burden in a case where there is a Federal tax sought to be laid on a State agency.

6. *Taxation of the employee's salary would interfere with the State's freedom of choice in its agents.*

It is of the essence of sovereignty that the sovereign shall be free to select those instrumentalities which are *or who*

are best adapted to the sovereign's needs. If it chooses to select individuals who will serve without compensation for the honor of service, it may do so. If it chooses to create a public corporation, it may do so. Its hands are not to be stayed by another sovereign. Now, it is clear that in the choice of human instrumentalities, the element of taxation upon compensation plays a vital part. It need not be argued that in each instance the sovereign must make up the tax in increased compensation. It is sufficient that the inducements the State may offer are cut down. It is sufficient to show an *interference* with the State's offer of compensation. Once this is shown, it necessarily follows that the sovereign's right to have a free choice of public servants is interfered with. Nothing more need be shown. To be sure, there is always competition between the attractiveness of public office and the greater compensation of private employment. Yet every man who studies his own budget knows that it is the *net* income upon which he relies in budgeting his living expenses—not the gross.

It is beside the point to argue that there is someone always ready to take the place of one who resigns from public employment. The fact is that men acquire knowledge and expertness by reason of their service in governmental employ. The community has an investment in the judge on the Bench who has served many years. The fact that if he retires someone is ready to take his place, is also beside the point. If reduction in his salary would tend in any degree to lead him to withdraw from public service, the sovereign's power to continue such an expert in its employ is directly interfered with. It is no answer to say that men who care for the honors of public office are likely to continue to make sacrifices. It is no answer to say that they may be able to make up the difference from the private incomes. *The real question is, has the State the necessary freedom to choose the type of instrumentality it desires?*

This issue was clearly decided in the *Rogers* case. There this Court said (p. 408):

> "The power of the federal government to use a corporation as a means to carry into effect the substantive powers granted by the Constitution has never been doubted since *McCulloch* v. *Maryland*, 4 Wheat. 316."

It is for this reason that the Court, finding that the selection of a corporation was necessary to the freedom of the exercise of the powers of sovereignty, applied the same doctrine to the lawyer employed by the corporation whose salary the State sought to tax.

Recently, the Solicitor General, Mr. Stanley Reed, in arguing *Dravo Contracting Company* case said that there was a great distinction between a tax on the salary of an employee of government and a tax on an independent contractor. He said in his argument there that a governmental employee is a part of the government itself, that such an employee has a continuity in and of the government, and that he represents and stands in the place of the government. The Solicitor General furthermore said that any attempt to tax an employee of the National or a State government *is a direct interference with its operation.* In concluding his argument, Mr. Reed said that if the Government were to ask a disregard of the principle of reciprocal immunity, it should have no standing even to be heard before the Court. He argued, too, in that case that taxing securities of a State or of the Federal Government was similarly distinguishable from a tax on an independent contractor, because bank holdings of Federal and State bonds form the very basis of our currency system, and any attempt to tax such an instrumentality of government would constitute a direct interference with the fiscal affairs of government.

The Court is not concerned with the question of the *extent* of the tax. The courts do not undertake to determine when the *amount* of any tax will constitute a burden and when it will not. Once we concede the power to levy a one per cent. tax, we concede the power to levy a fifty per cent. tax. The Court in these cases is concerned only with the *principle.* The interference with the sovereign's power and freedom to

choose employees and to offer whatever inducement in the way of compensation it may decide to offer, either to enter into or *remain* in its service, is certainly an unconstitutional "burden".

7. *The immunity doctrine has so long been in effect, and the States have so ordered their fiscal affairs accordingly, that the rule ought not to be disturbed.*

In the recent case of *Elkins* v. *Commissioner*, 91 F. (2d) 534, where the Commissioner challenged long standing Departmental practice, the court said:

> "Beyond the purpose of the taxing authorities to exact more from taxpayers, there is no logical reason to reverse this ruling of many years * * *."

Likewise here the fundamental reason for the challenge to the long-established Constitutional principle of immunity seems to be merely the desire of the Government to get more taxes. It is not as though there were not already many subjects of Constitutionally valid taxes. There is no real threat that the Federal Government will be left without sources of revenue. It simply is an attempt of one government to collect certain revenues at the expense of or to the embarrassment of the other government.

Many States, municipalities and State agencies have issued bonds to raise funds to establish and maintain particular governmental projects, such as bridges, traffic tunnels, and the like, and have provided that the interest on the bonds be paid out of tolls or other charges for the use of such facilities. If the Commissioner's theory be adopted, then such bond interest could no longer be regarded as exempt from the Federal income tax. This would strike down established methods of financing State activities, and would interfere with the States' freedom of choice in the methods of financing their projects.

If the source of the funds is to be considered, then it would have to be considered in every case where the com-

pensation was not paid directly out of general taxes. For example, the salary of the Clerk of this Court is paid out of the private funds of litigants who appear before the Court in just as real a sense as was respondent's salary paid out of the private funds of the banks whose liquidation was being supervised by the State of Pennsylvania. This Court is authorized to charge certain fees. Judicial Code, Sec. 223, Act March 3, 1883, c. 143, Sec. 1, 22 Stat. 631. That the Clerk's salary is a first charge against these fees was pointed out in *Bean* v. *Patterson*, 110 U. S. 401. But would this Court uphold the validity of a State income tax on his salary because he is paid out of such fees?

The Commissioner apparently will not carry his argument so far as to conclude that a salary paid out of fees so collected and covered into the treasury of one sovereign would be subject to income tax by the other. Cf. Commissioner's brief in *Therrell case*, p. 7. But there can be in principle no valid distinction between the payment of salaries out of fees charged for special services rendered by the State, whether or not covered into its treasury, and the payment of salaries out of other funds physically commandeered by the State and used by it to pay public employees for special services rendered to the original owners of such funds. As already stated, the difference relates merely to the method employed by the State in obtaining the funds to meet its own obligations. Before the Act of March 3, 1883, referred to in *Bean* v. *Patterson, supra*, apparently the Clerk of this Court was entitled to retain as his own all fees collected in excess of the expenses of his office. As the Court is aware there are still many States that authorize various officials to collect prescribed fees and to retain same as their compensation. Can it reasonably be urged that simply because of this particular method used in paying the officer or employee he thereby loses his right to claim exemption of his compensation from the Federal income tax, whereas a fellow officer or employee is concededly entitled to claim exemption because of the happenchance that his salary was

paid out of funds in the State treasury derived from general taxation?

This also illustrates the fundamental unsoundness of the principle contended for by the Commissioner. It would serve to classify State and Federal employees, not according to what they do, but according to how they happen to be paid.

The adoption of the Commissioner's principle would obviously necessitate an extensive overhauling of the methods of financing governmental activities. It is common knowledge that the tendency in recent years has been for both the State and Federal Governments to earmark certain receipts (whether collected as taxes, as fees, or otherwise) for the payment of the expenses of a governmental department or agency rendering a particular service to the individual citizens from whom the collections are made. It is but reasonable to surmise that the adoption of any such rule as that contended for by the Commissioner would merely drive the States to adopt a different method of accounting and of payment of salaries of officers and employees engaged in such governmental activities. To assure tax exemption to its officers and employees a State would merely have to provide that the special charges be paid into its treasury to the account of the general fund and that the salaries be paid out of this general fund. Such an involved process of changing the form of the transaction, without changing the substance, would remove the very ground of the Commissioner's claim for a tax in a case such as the present. It is clear, therefore, that the Commissioner's argument is predicated upon a matter of mere form of payment and not upon a matter of real substance. This Court has repeatedly held that in tax matters substance and not form should control.

The Commonwealth of Pennsylvania, frequently employs the sound policy of providing for the expenses of particular governmental functions, especially regulatory functions under the police power, by assessing the entire cost against the subject matter of the particular function. That is essen-

tially the case here. Sec. 9 of the Act of May 21, 1919, P. L. 209, provided that from and after the date of the approval of the Act—

> "all moneys derived by the Banking Department from fees, assessments, charges, penalties, and otherwise, shall be paid by the Commissioner of Banking into the State Treasury for safe-keeping, and shall, by the State Treasurer, be placed in a separate fund, to be available for the use of the Banking Department upon requisition of the Commissioner of Banking. All such moneys, so paid into the State Treasury, are hereby specifically appropriated to the Banking Department for the purpose of paying the salaries of the Commissioner, the Deputy Commissioners, the Examiners, and the other employees of the Department, and the expenses of the Department, including the rental of such rooms or quarters as the Commissioner of Banking may deem necessary outside of the Capital."

The method of paying the salaries of the head of the Banking Department and of all of his employees, which was inaugurated by that Act, has been continuously adhered to, although the old Act of 1919 is no longer in force. See Act of June 15, 1923, P. L. 809, Sec. 9, as amended by the Act of April 13, 1927, P. L. 182; Act of April 25, 1929, P. L. 716; and Act of May 15, 1933, P. L. 796. By the last mentioned amendatory Act this plan of paying Department of Banking expenses was extended to the supervision of the Department over building and loan associations. All of these Acts were repealed by the Act of May 15, 1933, P. L. 111, known as the Department of Banking Code, and Sec. 204 of this Act substantially restated the law as it previously existed. This is the current statute which provides that both banks and building and loan associations shall pay the cost of examination and supervision by the Department of Banking. Today there is no appropriation whatever out of the general funds of the Commonwealth to support the work of the Department of Banking.

The same method of financing the work of the Insurance Department of Pennsylvania is also in force. See Act of May 17, 1921, P. L. 789, Art. II, Sec. 211, as amended by the Act of April 7, 1927, P. L. 161, Sec. 1.

In the cases of examinations of banks, building and loan associations and insurance companies, the State now assesses the institution examined with the actual per diem cost of the examination computed according to the actual salaries and expenses of the examiners engaged in the work. An additional charge to cover the general overhead of the Departments is made against all supervised institutions according to the book value of their assets *pro rata*.

A modification of this method also prevails for financing the work of the State Game Commission and the State Fish Commission. In these cases, license fees are charged for the privilege of hunting and fishing, the fees are placed in special funds in the State treasury, and all expenses of supervision incident to the acquisition and maintenance of game preserves and fish hatcheries and the enforcement of the Game and Fish Codes are paid out of these funds. Not a penny of the State's general revenue is used for this purpose.

To a large extent the work of the Department of Highways is similarly financed. All motor license and drivers' license fees are paid into a special fund in the State treasury out of which are paid all of the expenses of the head and subordinate officers of the Department of Highways.

The adoption of the principle contended for by the Commissioner would then necessitate an examination into the source of the funds used to pay all these hundreds of State employees, and would require a holding that such of them as were not paid out of general taxes were not State instrumentalities carrying out governmental functions. That is not a sensible result. As above stated it would set up gross discrimination between classes of State employees, according not to their duties but to how they are paid.

In considering practical objections to a change in the

rule it should not be overlooked that the Commissioner's theory would inject greater uncertainty into the field of taxation and tend greatly to increase the already too large amount of tax litigation. Tax cases now clog the courts. But if the tax status of each State and Federal Government employee is to be determined by reference to the source of the funds used to pay his compensation then the number of tax controversies will be enormously multiplied. We now have a sound and workable rule that has stood the test of time. Here the maxim *stare decisis, et non quieta movere,* applies with great force.

8. *Any change in the immunity doctrine is a political question and ought to be left to a decision by the People upon submission of an appropriate amendment to the Federal Constitution.*

It is not clear whether the Commissioner here seeks a complete re-examination by this Court of the application of the reciprocal immunity principle in the case of governmental officers and employees. He says it is unnecessary to question the principle of *Collector* v. *Day*. But the result he seeks is so inconsistent with the rule of that case that he must at least seek a drastic limitation on the immunity doctrine. But this principle is of such long standing as to have become a part of our fundamental law. Apparently there is no longer left a proper question for judicial determination. It is now a question as to whether the People of the Nation desire to establish a new and different Constitutional rule, as in the case of the Sixteenth Amendment adopted after this Court held the income tax invalid as a direct tax under the Constitution as it existed prior to such Amendment.

It is common knowledge that many bills have been submitted in Congress proposing amendments designed to permit taxation of both the interest of government securities and the compensation of government employees. None has yet passed. The citizens of the Nation, as they speak

through their duly elected representatives, have not yet evidenced a sufficient desire to change the rule. In this case we have but an attempt of the Federal Government to extend its taxing powers to a field not heretofore recognized by our Constitutional law. Mr. Justice Holmes in *Baldwin v. Missouri*, 281 U. S. 586, 595 (1930), warned against the cutting down of the established constitutional rights of the States, saying:

> "I have not yet adequately expressed the more than anxiety that I feel at the ever increasing scope given to the Fourteenth Amendment in cutting down what I believe to be the constitutional rights of the States. As the decisions now stand, I see hardly any limit but the sky to the invalidating of those rights if they happen to strike a majority of this Court as for any reason undesirable."

II. The court below correctly held that, upon the Board's findings of fact, respondent must be classed as an employee of the Commonwealth of Pennsylvania.

Although the errors assigned in the petition for the writ and in the Commissioner's brief are broad enough to present this question for consideration, we are not sure whether the Commissioner intends to urge in this Court that respondent was not an employee of the State. Applying the principles established by the decisions of this Court, and by the great number of decisions of the lower courts and the Board of Tax Apeals, to the facts as found by the Board it seems clear that petitioner must be classed as an employee, and that there are no substantial grounds for claiming that he had the status of an independent contractor.

In his notice of deficiency, which was the basis of the appeal to the Board, the Commissioner did not claim that respondent was not an employee, but rested his denial of exemption on the ground that the source of the compensation precluded the application of the principle of immunity (R. 7-8). While in the Board of Tax Appeals the Commis-

sioner did urge that Freedman was an independent contractor, the Board in its opinion (R. 16-21) did not pass upon the question, resting its decision on the "basic ground" that the "source of his income precludes any possibility of a burden on the State resulting from a tax thereon" (R. 17).

The Commissioner in the court below made the point that Freedman was not "an employee of the State of Pennsylvania, so far as the rule of immunity is concerned", although specifically recognizing "that the petitioner here might well have been held to be an employee of the State of Pennsylvania under the facts held by the Board" (Commissioner's brief below, p. 40). On this issue the Circuit Court held (R. 64):

> "The uncontradicted testimony of the taxpayer was that 'the Department of Banking had absolutely no authority over me. They did not instruct me as to what banks I was to work. The Attorney General did that.' The Deputy Attorney General testified: 'It was considered that these men were available for any purpose at any time with the Department of Justice. They were controlled entirely by that department'. In view of this uncontradicted evidence, we hold it proven that the taxpayer was an employee of the State acting by its Attorney General."

The accuracy of the findings of fact made by the Board is not challenged. We are not, therefore, confronted with any problem as to whether there was substantial evidence before the Board to support its findings. Here the "function of the court is to decide whether the correct rule of law was applied to the facts found." *Commissioner* v. *Rankin,* 295 U. S. 123, 131. We submit that, on the facts found by the Board, the court below correctly held that Freedman was an employee and not an independent contractor, as those terms are defined in the many decided cases.

In *Commissioner* v. *Coughlin,* 87 F. (2d) 670, after quoting the relevant provisions of Art. 643, of Reg. 74, which

are identical with the provisions of the regulations applicable in this case, the court approved those regulations and defined an "employee" as follows:

> "According to those Regulations an employee is (a) one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and (b) one whose services are continuous, not occasional or temporary. In addition, the decided cases stress the importance of supervision and control. Where there is no supervision or control, where the employment is occasional, where the duties are not prescribed, the courts have concluded that the taxpayer was not an officer or employee and that his compensation was not tax-exempt."

The nature of the required control in the case of an employee who is a professional man is well stated in the case of *Curren* v. *Commissioner*, 34 B. T. A. 946, (affd. 90 F. (2d) 621, C. C. A. 2nd), where it was held, with respect to an attorney appointed as counsel to a county court clerk, that:

> "While it is true that petitioner was required to exercise, and did exercise, his independent judgment and best professional skill in rendering the services here involved, that is true in the majority, if not in all, of the cases where a professional man is employed. A chemist, bacteriologist, or technician in a laboratory, whether employed by a private industry or by a political subdivision, is required to exercise his independent judgment and best professional skill in performing the task assigned; but he may nevertheless be an employee if his employer retains the right of control over his activities and can direct how and when he shall perform his work. If, however, either an industry or a municipality engages a technician to deliver to it a completed task, and exercises no control over the means or instrumentalities whereby the results sought are achieved, and has no right to exercise such control, then the relationship between the parties is that of independent contractor rather than employer and employee.
>
> The courts and this Board has applied the above test in many cases and have held that even in the absence of

> the actual exercise of the right of detailed control, a professional man nevertheless may be an employee. Some of the cases are: *Charles J. Tobin*, 17 B. T. A. 1261; *Frederick A. Brown*, 22 B. T. A. 581; *D. F. Strickland*, 16 B. T. A. 419; *Burnet* v. *Livezey*, 48 Fed. (2d) 159; *R. E. McIntosh*, 16 B. T. A. 1400; *B. F. Martin*, 12 B. T. A. 267; *W. B. Mathews*, 13 B. T. A. 1133; *Rosalie C. Rand, Executor*, 27 B. T. A. 182; *George H. Harlan*, 30 B. T. A. 804; affd. 80 Fed. (2d) 660; *Jermiah Wood, supra; Joseph J. Sullivan*, 33 B. T. A. 629; *John B. Hittell*, 33 B. T. A. 276. The crucial test is the *right* to exercise control, which we believe the evidence clearly indicates the county clerk had as to this petitioner."

The facts in the instant case establish beyond question that the Attorney General had the right to direct not only what Freedman should do, but *how* he should do it; and the Attorney General not only had the right but fully exercised it. He did not leave Freedman to his own discretion. Instead, as specially found by the Board (R. 14) respondent—

> "was free to use his discretion only in simple matters. In regard to all proposed litigation and appeals, he was required first to consult with his superior officers. He was required to follow prescribed forms issued by the Attorney General's office as to preparation of documents and pleadings. His legal opinions were reviewed and often revised by his superiors before being issued. Likewise, briefs were reviewed and frequently entirely redrafted. All matters of policy in particular cases were decided by the Attorney General and his deputies. The petitioner's advice to depositors of closed banks was limited to matters on which his superiors had ruled. All such attorneys were instructed to take no steps and render no opinions on any legal problem involved in closed banks without approval of the Attorney General."

Not only is there here present that "control or right of control by the employer which characterizes the relation of employer and employee and differentiates the employee or servant from the independent contractor" (*Metcalf & Eddy*

v. *Mitchell,* 269 U. S. 514, 521), but there are also here present those other factors deemed by Art. 643 of Reg. 77, *supra,* as establishing the relation of employer and employee. That regulation, which controls this case, provides:

> "An employee is one whose duties consist of the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary".

There can be no question but that respondent was employed to, and did render "*prescribed services*". His appointment as an attorney in the Department of Justice was made by the Attorney General pursuant to a specific statutory provision giving that official power to make the appointment (R. 12). The powers of the Attorney General and the Department of Justice are defined by the Pennsylvania Administrative Code and by other state statutes. The very terms of respondent's appointment were that "you will be available to assist them (the Special Deputy Attorneys General) in any way in which they may find it necessary to call upon you" (R. 12). The Board found (R. 13-15) that:

> "The petitioner was assigned to work under Special Deputy Attorneys General in Philadelphia County in connection with legal matters pertaining to closed banks in that county. * * * The petitioner's duties consisted * * * and 'in general anything that was assigned by the Special Deputy Attorney General at the time'. Such attorneys were considered by the Department of Justice as 'available for any purpose at any time.' * * * The particular work and the matters to which the petitioner gave attention were determined by the Attorney General's office. * * * The petitioner's duties and the manner in which they should be performed were prescribed in part by a large number of mimeographed circulars issued by the Attorney General at Harrisburg at frequent intervals and sent to all attorneys handling closed bank matters. Also, his instructions were received periodically from a Deputy Attorney General at regular meetings held for the pur-

pose of discussing their problems and deciding on procedure."

Also Freedman's services were "continuous, not occasional or temporary". He served for a continuous period of 3 years and 4 months (R. 11-12). He was not appointed for any given period of time (R. 12). He was simply appointed as an attorney in the Department of Justice at a salary, pursuant to provisions of State law, and was removable at the will of the Attorney General, as in case of all such attorneys in that Department. Respondent was actually removed by action of a new Attorney General (R. 12, 32).

Material also (cf. *Coughlin* v. *Commissioner, supra*) is the fact that respondent received a fixed annual salary, payable bi-monthly in the same way and at the same time as other State employees (R. 15). No matter how much of his time or what the character of his services he was entitled to receive $3,000 per year, and no more (R. 15). While he was only called upon to give about 50 per cent of his time to the State in 1932, the Board found that "the Department of Justice could have required all of his time and had first call on his services" (R. 15).

Another controlling factor is the fact that respondent's duties were not prescribed by any contract but solely by his superiors in the Department of Justice. Here there was no contract defining his duties. If told to do something respondent could point to no contractual right which limited his services; he had but to obey, or to resign.

III. Respondent was employed by the State in the enforcement of its statutes relating to the regulation of banking and was necessarily engaged in carrying out essential governmental functions of the State, this having been conceded by the Commissioner in the court below.

When this case was before the Board, counsel for the Commissioner presented a brief argument—hardly more than a suggestion—that Freedman's services were not rendered in

connection with the exercise of an essential governmental function of the Commonwealth of Pennsylvania. The Board did not mention this question in its opinion (R. 16-21). It is significant that in the deficiency notice (R. 5-9) the Commissioner did not deny exemption on any such ground.

In the court below the Commissioner not only did not raise the point but conceded Freedman to have been engaged in an essential governmental function. In the brief there, at pages 12 and 14, counsel for the Commissioner stated:

> "We recognize that the State of Pennsylvania, and each other state, has the capacity under its police power to regulate banking within its boundaries and under that power to take over and liquidate insolvent banks. *Engel* v. *O'Malley*, 219 U. S. 128; *Noble State Bank* v. *Haskell*, 219 U. S. 104; *Therrell* v. *Commissioner* (C. C. A. 5th), decided March 9, 1937.
>
> • • •
>
> Since the State of Pennsylvania admittedly has the power to take over and liquidate insolvent banks and that power was exercised here, we come to the question of whether the rule of immunity applies in this case to exempt the compensation received by the petitioner from Federal income taxation in assisting the state in certain liquidations."

In the light of such admission the court below was not called upon and did not pass on the question now raised by the Commissioner in the first point of his brief in this Court. The court below rested its decision on the express assumption that Freedman was "an employee of the State engaged in recognized Governmental work—in this case the vital Department of Banking (*Therrell* v. *Commissioner*, 88 F. (2d) 869)."

In the first place, Freedman was an employee of the Pennsylvania Department of Justice—he was a law enforcement officer. He was subject to call for any duties in that Department which the Attorney General might have prescribed

(R. 13-14). It happens he was assigned to give legal assistance in enforcing those State statutes having to do with the liquidation of insolvent State banks. Whatever the character of the laws he may have been called upon to enforce, we submit that simply as a law enforcement officer he was necessarily engaged in the performance of essentially governmental functions.

But even if the case is viewed from a narrower angle, and his employment considered as limited (which it was not) to matters relating to closed banks, nevertheless we come to the same conclusion.

The supervision and control of banking has been considered as a governmental function since the beginning of our government, both by the Federal and by every State Government. It is expressly so recognized by the Pennsylvania Constitution and statutes. Pennsylvania Constitution of 1874, Art. XVI, Sec. 10, and Art. XVI, Sec. 11, as amended November 2, 1930. The subject has been deemed of such public importance that a separate executive department of the State Government known as the Department of Banking was created. Act of April 9, 1929, P. L. 177, Art. II, Sec. 201. It is given wide supervisory and regulatory powers over both going and closed banks. Further, banking is of such public importance that in 1933 the legislature adopted an entire "Department of Banking Code." Act of May 15, 1933, P. L. 111.

As pointed out in Appendix B to the Commissioner's brief in the *Therrell* case, in essence the procedure adopted by the Commonwealth of Pennsylvania for the liquidation of insolvent banking institutions, is "administrative determination of insolvency, followed by administrative liquidation or administrative appointment of receiver; subject to limited judicial supervision." Purdon's Statutes, Title 7, Secs. 21-50.

In *Pennsylvania* v. *Williams*, 294 U. S. 176 (1934), this Court held that the provisions of the very same laws which Freedman was here employed to help enforce, created the

Pennsylvania Secretary of Banking a State agency of such a character that its functioning should not be interfered with by the Federal Government, acting through its courts. That was a suit in a Federal District Court by a shareholder for the appointment of receivers to liquidate an insolvent building and loan association, appropriate jurisdictional facts appearing. The Commonwealth of Pennsylvania intervened and petitioned the District Court to surrender possession of the assets of the association to the Secretary of Banking in order that he might liquidate its affairs pursuant to the Pennsylvania Banking Act of 1923, P. L. 809, as amended. This Court held that the District Court should have relinquished its jurisdiction in favor of State administration by the State officer, saying, Mr. Justice Stone writing the opinion:

> "Here no state court is asserting jurisdiction, but the state officer, charged by the statutes of the state with the duty of supervising its own building and loan associations *and of liquidating them by an adequate procedure when insolvent,* asks to proceed with the liquidation. See *Amos* v. *Trust Co. of Florida,* 54 F. (2d) 286, 288 (C. C. A. 5th).
>
> A court of equity, which in its discretion may refuse to protect private rights when the exercise of its jurisdiction would be prejudicial *to the public interest,* see *Greathouse* v. *Dern,* 289 U. S. 352, 359, 360, or deny relief upon performance of a condition which will safeguard the *public interest* and secure substantial justice to the complainant, see *Harrisonville* v. *Dickey Clay Co.,* 289 U. S. 334, 338, would seem bound to stay its hand in the *public interest* where it reasonably appears that the private right will not suffer. It is in the public interest that federal courts of equity *should exercise their discretionary power with proper regard for the rightful independence of state governments in carrying out their domestic policy.* * * * It has long been accepted practice for the federal courts to relinquish their jurisdiction in favor of the state courts, where its exercise would involve control of or interference with the internal affairs of a domestic corporation of the state. * * *

There are stronger reasons for adopting a like practice where the exercise of jurisdiction involves an unnecessary interference by injunction with the lawful action of state officers. Matthews v. *Rodgers, supra,* 525."

This Court has thus expressly recognized that the liquidation provisions of the Pennsylvania Banking Act are in the "public interest" and transcend the mere protection of "private rights." The denial of the right of the District Court to retain jurisdiction of the liquidation proceedings was grounded upon the very principle which Freedman asserts precludes the Federal taxing authorities from taxing his services rendered in enforcing those same State laws, namely, that it would result in "an unnecessary interference * * * with the lawful action of state officers." We believe that the decision in *Pennsylvania* v. *Williams* leaves no room for an argument that the supervision of the liquidation of insolvent Pennsylvania financial institutions is not an exercise of State governmental functions of such a characted that they may not be interfered with by the Federal Government.

We believe that the assumption by the Commissioner in his argument in the court below that the taking over and liquidation of insolvent banks is a usual or essential Governmental function is sound, and that the position which he now takes in this case and in the *Therrell* case is clearly erroneous. "The business of banking is a proper subject for regulation under the police power of a state because of its nature and the relation which it bears to the fiscal affairs of the people and the revenue of the state." 7 C. J. 480.

In his brief (pp. 11-12) in the *Therrell* case the Commissioner urges that the "liquidation of financial institutions by the states" is not an essential governmental function. However, at the outset, he "concedes that the *regulation* of the state banking institutions is an essential governmental function" but contends that *liquidation* thereof is within the "zone of debatable ground" referred to in

Brush v. *Commissioner*, 300 U. S. 352, 365, and "more akin to the operation * * * of the state financial institutions". His argument then goes off on the narrow issue as to whether a bank liquidator, although an administrative officer of the State, is to be considered as merely carrying on a private banking business reduced "in the scope of the activities". He argues that since the activities of a solvent bank include the sale of assets and the collection of loans, and that since the liquidator's duty consists chiefly in carrying out these same activities, it follows that the liquidator is carrying on an ordinary banking business. Such argument proves too much. It goes without saying that a private banking business is conducted primarily for the purpose of making a profit. The nature of any undertaking is determinable by reference to its *purpose*. But the activities of a liquidator have no such purpose of gain, but, on the contrary, the opposite purpose of *closing up* a going business. The winding up of a business is the very antithesis of carrying on an enterprise. His purpose is to insure a fair and economical liquidation to the end that the interests of the general public, the creditors, the depositors, and the shareholders of the insolvent bank may be protected, that no one group may be permitted an advantage over another, and that there may be a minimum of disturbance in the fiscal affairs of the State and the citizens. Thus his activities clearly are essentially regulatory in nature.

Helvering v. *Powers*, 293 U. S. 214, is not only no authority in support of the Commissioner's contention but affirmatively supports the view that liquidation of financial institutions is a governmental function. It was there held that public trustees of the Boston Elevated Railroad Company were not entitled to tax immunity on the ground that their activities were not of a governmental nature, because, as stated by the Court at page 223-224:

> "While the undertaking is for the public benefit, it is still a particular business enterprise—the operation

> of a street railway—and the functions of the trustees are limited accordingly. * * * the operation by the trustees is intended to be self-sustaining. The transportation service is to be rendered, * * *. The authority given to the trustees 'to regulate and fix fares,' and the further authority to ascertain such losses as may be incurred, which are to be borne by the Commonwealth, are both incident to that main purpose."

So in the *Powers* case the *main purpose* was the *continued operation* of an ordinary private business enterprise—not its regulation. Here, on the other hand, the only purpose is the regulation of the processes of liquidation. Concededly the State had the power of regulation. It is immaterial how this power is exercised. As long ago laid down by Chief Justice Marshall in *McCulloch* v. *Maryland*, 4 Wheat. 316, 409:

> "The government which has a right to do an act, and has imposed on it the duty of performing that act, must, according to the dictates of reason, be allowed to select the means; and those who contend that it may not select any appropriate means, that one particular mode of effecting the object is excepted, take upon themselves the burden of establishing that exception."

That the liquidation of insolvent banks is a commonly accepted governmental function of the States is not open to question. The Commissioner's brief itself demonstrates this. He attaches to his brief as Appendix B a rough classification of the procedures adopted by the several States for the liquidation of insolvent banking institutions. Every State in the Union has a law on the subject.* If not historically an essential governmental function, administrative liquidation has become such by reasons of modern conditions recognized generally by the State legislatures

*The Commissioner makes reference to the statutes of every State except Indiana. That State also provides for administrative liquidation. Burns' Ind. Statutes (1933), Sec. 18-301.

as requiring public rather than private liquidation proceedings.

The argument is also made that since the banks were subject to Federal taxation before being taken over by the State the case is governed by the principle stated in the *Powers* case that one of the limitations on the principle of immunity is—

> "that the State cannot withdraw sources of revenue from the federal taxing power by engaging in businesses which constitute a departure from usual governmental functions and to which, by reason of their nature, the federal taxing power would normally extend."

Such contention is clearly invalid. It assumes that supervising the liquidation of banks is a "business" and also involves "a departure from usual governmental functions" neither of which has a factual basis. State supervision of insolvent financial institutions is not now, and never has been, a business. That activity has never been subject to Federal taxation. As pointed out by the court below (R. 65)—"As the national banks are 'instrumentalities, means and operations' whereby the Federal Government exercises a governmental control over them, so the state exercises like governmental control over state banks, * * *". The court in the *Therrell* case seems clearly correct in its holding that the—

> "orderly winding up of State banks is a true governmental function of the State resting not only on its fiscal needs and powers but also on its police powers."

The Commissioner makes the curious point that the liquidation of insolvent banks cannot be an essential governmental activity, for purposes of applying the immunity rule, "because many states permit or require the activity to be undertaken by the Federal Government itself". But this argument seems only to show even more clearly that

the function is considered by both the Federal and State Governments as so essentially governmental and of such nation-wide public importance that their efforts should be coordinated. The fact that the State surrenders a power to the Federal Government or, rather, makes the Federal Government the agent of the State to carry out more effectively the powers of regulating local banks, cannot be a point against the governmental character of the function. To carry the Commissioner's contention to its logical conclusion would authorize the several States to tax the compensation of all the officers and employees of the Federal Deposit Insurance Corporation. That agency has strenuously resisted taxation by the State of the salaries of its employees on the ground that this constitutes a direct interference by the States with the activities of a National instrumentality. It has been sustained in that contention only recently. In a formal opinion dated October 25, 1937, the County Board of Review for Dana County, Wisconsin, in a preceeding entitled *In Re Fred W. Niles,* held the salary of Niles, received as an employee of that Corporation, was exempt from the Wisconsin income tax, on authority of *New York ex rel. Rogers* v. *Graves,* 299 U. S. 404. The position of the Federal Deposit Insurance Corporation is that its liquidation and operation activities are but incidental to the undoubted power of the Federal Government to regulate banking in its national scope, just as the operation of a railroad and a canal in the *Rogers* case was considered but an auxiliary activity in the function of the Federal Government of providing for the National defense and the regulation of commerce.

Lastly, we come to consider *Brush* v. *Commissioner,* 300 U. S. 352. The Commissioner says it has no application. It was there held that maintenance of a municipal water supply system was a governmental function. The Commissioner seeks to limit that case to a situation where there is a showing as to the necessity of the State activity, and argues therefrom that the State "would continue to exist

without substantial change whether or not a State official undertook the liquidation of insolvent banks". The trouble is with the premise. In the *Brush* case the Court laid down no such doctrine of necessary function but, on the contrary, rejected it. In the argument of that case it was strenuously urged by the Government that a municipality could get along without a publicly owned or operated water supply, it being pointed out that many cities and towns were served by private companies. The true principle of the *Brush* case is that specifically stated in the opinion that—

> "if the State and City of New York be of opinion, as they evidently are, that the service should not be entrusted to private hands but should be rendered by the city itself as an appropriate means of discharging its duty to protect the health, safety and lives of its inhabitants, we do not doubt that it may do so in the exercise of its essential governmental functions."

In this case the People of Pennsylvania have clearly expressed their "opinion", through the enactment of statutes by the legislature, that the liquidation of closed banks should not be entrusted to private hands, but should be undertaken by the State itself. The State policy is expressed in the following statutory provisions:

> "*Enforcement of Banking Laws.*—The Department of Banking shall enforce and administer the laws of this Commonwealth in relation to all corporations and persons under its jurisdiction, and shall see that the greatest possible safety is afforded to depositors therein or therewith, and to other interested persons." (Act of April 9, 1929, P. L. 177, Art. XVI, Sec. 1603.)

Just as in the *Brush* case the "acquisition and distribution of a supply of water for the needs of the modern city involves the exercise of essential governmental functions", so here the establishment and maintenance of an adequate and responsible banking system for the needs of the modern State and its citizens involves the exercise of like essential

governmental functions. In this connection reference is made to the very sound argument presented under Point II of respondent's brief in the *Therrell* case.

The Commissioner of Internal Revenue long held that the functions of a State banking department are essentially governmental. In a ruling published in 1922 (I. T. 1316, I-1 C. B. 105), the Commissioner held in respect of employees of a state banking department:

> "Their employment is directly connected with the exercise of a State governmental function and is a part of the administration of the State banking laws."

In I. T. 2233 (IV-2 C. B. 47), issued in 1925, it was held:

> "The department of agriculture, the highway department, and the *department of banking* are agencies or instrumentalities of the State used in connection with the exercise of essential governmental functions of the State and the compensation of the officers and employees of such departments is exempt from income tax."

In I. T. 2214 (IV-2 C. B. 46) a State bank receiver claimed exemption. It was held:

> "His duties are prescribed by statute within the meaning of article 88, *and he is engaged in performing an essential governmental function, namely, the administration of the State banking laws.*
>
> * * * * * * * *
>
> In view of the foregoing, it is held that receivers of insolvent State banks in Kansas are officers of the State engaged in performing an essential governmental function and their compensation from this source is exempt from Federal income tax."

And again in 1933 the Commissioner ruled that the administration of State banking laws, including the supervision of liquidation of insolvent banks, is a governmental function. I. T. 2710 (XII-2 C. B. 79).

If the operation of a water supply system can be held to be a governmental function because an auxiliary to the sovereign power of preserving the health and life of citizens (*Brush* v. *Commissioner, supra*); if the operation of a railroad and a canal can be held to be a governmental function because an auxiliary to the power to provide for national defense and to regulate commerce (*Rogers* v. *Graves, supra*); and if the operation of a national bank is a governmental function because an auxiliary to the powers of the Federal Government to provide for the financing of its activities; then, upon every reason advanced in those cases, the liquidation of insolvent financial institutions, whether by the State or the Federal Government, and by whatsoever agency or instrumentality selected by them, must likewise be held to be a usual or essential governmental function, being an auxiliary to the undoubted sovereign powers to regulate banking and to provide for the financing of all public activities.

IV. In all events, respondent's salary is not taxable, because he has brought himself within the specific terms of the exemption prescribed by Art. 643, Reg. 77.

Since it is shown (a) that respondent received his salary as an employee of a State, and (b) that his services were rendered in connection with the exercise of an essential governmental function, it follows that he has brought himself squarely within the terms of Art. 643, Reg. 77, *supra*. In the concurring opinion of Mr. Justice Stone and Mr. Justice Cardozo in the *Brush* case they held:

> "We concur in the result upon the ground that the petitioner has brought himself within the terms of the exemption prescribed by Treasury Regulation 74, Article 643, which for the purpose of this case may be accepted as valid, its validity not being challenged by counsel for the Government."

The terms of this regulation are not open to challenge. They stand unrepealed and have repeatedly been considered

and sustained by the courts. *Commissioner* v. *Coughlin, supra.* Essentially similar provisions were contained in the regulations under all the prior revenue acts. Art. 643, Reg. 74 (1928 Act); Art. 88, Reg. 69 (1926 Act); Art. 88, Reg. 65 (1924 Act); Art. 88, Reg. 62 (1921 Act); Art. 85, Reg. 45 (1918 Act); Art. 5(g), Reg. 33 (1917 Act).

It will be noted that the regulations say nothing about the source of the funds used to pay the compensation. It is only recently that the Department has sought to question the long establishd immunity principle so concisely stated in its own regulations.

We cannot conclude without suggesting that any doubt as to the right to exemption, either under the terms of the regulations or under the principles of the doctrine of immunity, must be resolved in favor of the taxpayer; also that the so-called presumption against immunity from taxation must here give way to the superior principle of Constitutional law requiring a minimum of interference between the powers of the State and the Federal Governments. As stated in *Metcalf & Eddy* v. *Mitchell, supra:*

> "But neither government may destroy the other nor curtail in any substantial manner the exercise of its powers. Hence, the limitation upon the taxing powers of each, so far as it affects the other, must receive a practical construction which permits both to function with the *minimum of interference* each with the other."

And the fundamental reason for the rule, as announced in *McCulloch* v. *Maryland, supra,* likewise requires all doubts to be resolved in favor of non-interference with State powers. There Chief Justice Marshall said that the rule of immunity is "a principle which is safe for the States and safe for the Union", and that by it—

> "we are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up;

from the incompatability of a right in one government to destroy what there is a right in another to preserve."

CONCLUSION.

Respondent's compensation was a fixed annual salary paid to him by the Commonwealth of Pennsylvania for services rendered as an employee of such Commonwealth engaged in carrying out a proper governmental function, and such compensation is therefore not subject to the Federal income tax. Neither the method used by the Commonwealth to secure the funds with which to pay such salary, nor the source of those funds, are material.

It is submitted that the judgment of the Circuit Court of Appeals for the Third Circuit, holding the proposed tax invalid, should be affirmed.

Respectfully submitted,

JOHN W. TOWNSEND,
Attorney for Respondent.

December, 1937.

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Supreme Court of the United States

OCTOBER TERM, 1937.

No. 597

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CLARENCE M. FREEDMAN,
Respondent.

BRIEF OF AMICUS CURIAE FILED ON BEHALF OF CHARLES C. STILWELL.

HERBERT POPE,
Amicus Curiae.

December 10, 1937.

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